Non-GAAP Financial Measures
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Executive Summary

Companies have used financial measures that depart from generally accepted accounting principles (GAAP) for decades to gain insights about financial performance beyond what can be gleaned from financial statements prepared in accordance with GAAP, and they are not going away anytime soon. In fact, use of non-GAAP measures—measures of performance or liquidity that differ from those presented in financial statements or computed in accordance with GAAP—is on the rise, and so is U.S. Securities and Exchange Commission (SEC) scrutiny.

As depicted in the table below, the average difference between GAAP earnings per share (EPS) and non-GAAP EPS for companies in the Dow Jones Industrial Average increased more than 160 percent from 2014 to 2015.

<table>
<thead>
<tr>
<th>Changes in the Use of Non-GAAP Measures</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average difference between GAAP EPS and non-GAAP EPS for companies in the Dow Jones Industrial Average</td>
<td>11.8%</td>
<td>30.7%</td>
</tr>
</tbody>
</table>

Source: SEC Flash Report Guidance on Non-GAAP Measures

The trend of presenting non-GAAP measures that significantly differ from U.S. GAAP has caught the SEC’s attention. In May 2016, the SEC’s deputy chief accountant termed as “troubling” the use of non-GAAP measures that are “inconsistent with the actual design of the business” or are inconsistent with the “risks that the business has undertaken.” In October 2016, SEC Chair Mary Jo White told an investor panel advising audit regulators: “The topic of non-GAAP measures is one that has and continues to receive a lot of attention at the commission. We have taken a number of steps in response to growing concerns that I and others have had about the appropriateness of certain reporting practices in this area.” SEC officials are concerned that non-GAAP financial measures can potentially mislead investors, can obscure the relevant U.S. GAAP measures, may not be comparable among companies or between periods, and may not be sufficiently transparent.

The SEC’s Division of Corporation Finance chief accountant said the commission would “crack down” on improper use of non-GAAP measures, and it has. Its sharp examination of non-GAAP measures—and communications to registrants—was underway with 2016 quarterly filings, and is expected to continue in an upward trend with the 2016 annual filings and quarterly and annual filings thereafter. Surpassing fair value measurements and revenue recognition, SEC comment letters on non-GAAP measures were the second most frequent topic in 2016 (comments on management’s discussion and analysis (MD&A) ranked number one in 2015 and 2016).

The heightened focus centers on whether companies’ use of non-GAAP financial measures might mislead investors with what the SEC considers dubious benchmarks not compliant with all aspects of non-GAAP measure regulations. SEC’s latest guidance published in May 2016, Compliance and Disclosure Interpretations (C&DI), provides views on adjustments the SEC believes could lead to distorted non-GAAP presentations and insight into what might constitute improper use of these measures. The 2016 C&DI aims to reduce registrants’ subjective interpretation of Regulation G and Item (e) of Regulation S-K (regulations explained in Appendix A) and improve compliance.

This article covers the rules around reporting requirements, prohibitions and the 2016 CD&I. It applies to non-GAAP measures presented in documents filed with the commission and also earnings releases furnished under Item 2.02 of Form 8-K.

Companies that modify or eliminate their non-GAAP measures to comply with the new parameters may find it necessary to develop a transition and communication approach that mitigates investor and analyst concern. Those that do not assess the guidance and make self-corrections run the risk of amplified SEC scrutiny in the form of comments or even forced revisions.
Non-GAAP Financial Measures

2016 Compliance & Disclosure Interpretations: Non-GAAP Financial Measures

Prompted in part by a speech by SEC Chair White in 2015 that emphasized non-GAAP measures should comply with rules, the SEC’s Division of Corporation Finance issued 12 new updates to its non-GAAP C&DIs. 2016 Compliance and Disclosure Interpretations: Non-GAAP Financial Measures provides clarifying explanations and example target areas of frequent SEC staff comment. These include misleading non-GAAP financial measures, using individually tailored revenue or measurement principles, presenting non-GAAP measures more prominent than GAAP measures, various liquidity measure topics and taxes.

Misleading Non-GAAP Measures

Inconsistency Between Periods

A non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods could violate Rule 100(b) of Regulation G unless the change between periods is disclosed and the reasons for it explained.

For example, changes in the method of calculating or presenting earnings before interest and tax (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA) from one period to another without a complete description of the change may violate Regulation G—even when the use of EBITDA in and of itself otherwise complies with Regulation G.

The SEC recognizes the difficulty a registrant may encounter when it stops providing a non-GAAP measure once it is established. The SEC provided guidance in the C&DI about transitioning out of a measure so as to avoid the “red flag” interpretation that can result when a company discontinues a measure.

Depending on the change’s significance, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context. For transition purposes, registrants could disclose in a periodic filing their intent to discontinue use of a non-GAAP financial measure. Registrants also could start bridging disclosures to provide a roadmap for analysts and help them reconcile a change in disclosures.

Excluding Charges but Not Excluding Gains

An adjustment that excludes one-time charges without an adjustment that excludes one-time gains that occurred during the same period could be misleading.

Commonly termed “cherry picking,” this often entails a registrant providing a misleading measure caused by a bias toward only adjusting costs that may be excluded, instead of costs and gains. An example is a registrant adjusting for one segment’s costs because that segment did not generate operating revenue, while not considering the elements of an unusually high-revenue-generating segment.

Describing a Charge or Gain as Nonrecurring, Infrequent or Unusual

Companies are not allowed to adjust “or smooth” non-GAAP financial measures to exclude items identified as “nonrecurring, infrequent or unusual,” when the nature of the gain or charge is such that it has occurred within two years or is reasonably likely to occur within two years. The SEC makes no exception for charge or gain items that were believed to be not reasonably likely to recur when made, but did recur. Litigation charges are one such example.
Non-GAAP Financial Measures

Excluding Normal, Recurring, Cash Operating Expenses

A non-GAAP performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant’s business may be misleading. While there is no per se prohibition against removing a recurring item, companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance.

Whether a non-GAAP financial measure that eliminates a recurring item or items from the most directly comparable GAAP financial measure is acceptable depends on all the facts and circumstances.

Labeling an adjustment as nonrecurring does not necessarily make it so. Companies will need to consider what “normal, recurring, cash operating expenses” are necessary based on their own facts and circumstances, with the expectation that the SEC will scrutinize an adjusted performance measure. For example, a company in the business of restructuring other companies may not be able to apply a “blanket approach” to excluding acquisition-related expenses and restructuring charges; likewise for advertising and marketing expenses of a consumer products company.

Companies are encouraged to go through the exercise of drafting expanded disclosures and discerning whether the non-GAAP measure meets the usefulness threshold, can stand the test of time and is not prohibited based on the “anti-smoothing” provision. Recurring adjustments where an entity attempts to use a non-GAAP financial measure to smooth earnings, in particular, are likely to be scrutinized by the SEC—regardless of their labeling as recurring or nonrecurring.

Individually Tailored Recognition & Measurement Principles

Non-GAAP measures exclude or include certain GAAP items from GAAP measures. Adjustments that substitute individually tailored recognition and measurement methods for those required under GAAP are not allowed.

An example of individually tailored adjustments to GAAP recognition and measurement methods is accelerating the recognition of deferred revenue to the time of sale or customer billing instead of ratably recognizing it over the performance period.

The SEC warned that companies presenting adjusted revenue likely will get a comment letter and “can expect the staff to look closely, and skeptically, at the explanation as to why the revenue adjustment is appropriate.” Enforcement actions are possible if the SEC believes a company’s conduct is egregious.

Non-GAAP Liquidity Measures

Presented on a Per-Share Basis

GAAP prohibits per-share cash flow information and as such, non-GAAP, per-share measures of generated cash are prohibited in materials furnished to or required to be filed with the SEC. The prohibition test rests on whether the non-GAAP measure can be used as a liquidity measure, even if the registrant solely presents it as a performance measure or describes a connection to operating performance. If so, the per-share measure is disallowed.

Non-GAAP, per-share performance measures should be reconciled to GAAP EPS. Special rules apply to FFO (funds from operations)—a common metric for valuing Real Estate Investment Trusts (REIT) stocks.
Non-GAAP Financial Measures

SEC staff will focus on the substance—and not management’s characterization—of the non-GAAP measure. If the measure is only or more useful in providing meaningful information regarding cash flows, including the registrant’s ability to meet future debt service, capital expenditures and working capital requirements, it is probably a liquidity measure.

Some measures are inherently hybrids of performance and liquidity measures. For example, although EBIT and EBITDA are commonly viewed as performance measures, earnings adjusted for non-cash expenses may be construed as an indication of cash flows and a measure of liquidity. Hence, EBIT and EBITDA should not be presented on a per-share basis.

Free Cash Flow

Free cash flow is typically calculated as cash flows from operating activities as presented in the statement of cash flows under GAAP less capital expenditures. However, the measure does not have a uniform definition and its title does not indicate how it is calculated.

Registrants should provide a clear definition of free cash flow and reconcile it to cash from operating activities. They also should avoid a potentially misleading title and description that implies the measure represents the residual cash flow available for discretionary expenditures, particularly if the company has mandatory debt service requirements or other non-discretionary expenditures not deducted from the measure. Free cash flow is a liquidity measure that must not be presented on a per-share basis.

EBIT & EBITDA

Item 10(e) refers to EBIT and EBITDA in the context of non-GAAP liquidity measures. If a company presents these or other similar non-GAAP measurements as a performance measure, rather than as a liquidity measure, it should reconcile the measurements to net income as presented in the statement of operations as defined by GAAP. This is the most directly comparable GAAP measure. In all uses, the term “earnings” is intended to mean net income as presented in the statement of operations under GAAP.

Measures that are differently calculated than those described as EBIT and EBITDA should not be characterized as “EBIT” or “EBITDA.” Instead, these measures’ titles should clearly identify the earnings measure being used and all adjustments. Such “adjusted EBIT” and “adjusted EBITDA” amounts are not exempt from the provision of Item 10(e) of Regulation S-K that prohibits excluding charges or liabilities that required, or will require, cash settlement from the non-GAAP liquidity measure.

Registrants that measure EBIT and EBITDA differently than their acronym descriptions are effectively revising the labeling of the widely used and recognized measures, e.g., by excluding additional charges such as impairments, severance and restructuring. Accurate labeling and explanation of the reconciling items is key to deterring comment letters in this area.

Presenting “EBITDA to operating cash flows” can be a sample non-GAAP debt covenant liquidity measure. It is important to note that although the measure may be presented as a liquidity measure, EBITDA is still required to be reconciled to net income as its own non-GAAP performance measure.
Non-GAAP Financial Measures

Prominence

A registrant who presents non-GAAP measures is required to present them in a clearly titled format that gives them no greater prominence than GAAP results. This supports the underlying principles in Regulation G and Item 10 (e) of Regulation S-K that non-GAAP measures should supplement, not supplant GAAP measures. Non-GAAP financial measures may not be included in financial statements and the accompanying notes.

Predominance refers to the order and manner of presenting non-GAAP information—as well as the emphasis placed on non-GAAP measures and discussions—versus comparable GAAP measures and discussions. Prohibited examples include:

- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP information
- Preceding the GAAP measure by a non-GAAP measure in an earnings release headline or caption
- Preceding a GAAP sentence or column by a non-GAAP sentence or column in a paragraph or table
- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures
- Presenting a non-GAAP measure using a predominant font or style (bold) that emphasizes it over the GAAP measure, including the use of headlines
  - Describing non-GAAP measures as “record” or “exceptional” when GAAP measures are not presented the same way

*Predominance generally depends on the facts and circumstances in which the disclosure is made.*

Taxes

A registrant choosing to present the income tax effects of adjustments should do so based on the measure’s nature. In situations where the measure is a liquidity measure, it may be most appropriate to adjust GAAP taxes within that measure to show taxes paid in cash. In situations where a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability and avoid using cash basis tax effects. Adjustments to arrive at a non-GAAP measure should not be presented “net of tax.” Instead, adjustments should be shown as a separate adjustment and clearly explained.

*Registrants should provide disclosures that clarify how the tax effect was calculated. In situations where there is a loss for GAAP (zero tax rate) and not for non-GAAP, the SEC is likely to scrutinize how the company calculates the tax rate. Companies are encouraged to document and disclose a thoughtful, rational process for determining the tax rate used.*

Additional Background & Definitions

Use of Non-GAAP Measures

Companies and users generally agree that use of non-GAAP financial measures can provide additional insight into a business and portray a more meaningful picture of a company’s operating performance and liquidity than financial reports prepared under GAAP alone. Non-GAAP measures are often requested by analysts, and particularly for earnings given more attention by analysts and the media over GAAP measures.
Non-GAAP Financial Measures

Issuers of public company financial statements often use non-GAAP measures in press releases, earnings calls or other unaudited documents as well as in registration statements filed under the Securities Act of 1933, and periodic reports filed under the Securities Exchange Act of 1934. In general, as long as the company reports under GAAP, it has the option to also report non-GAAP measures, and regulations apply to both.

Unaudited non-GAAP measures publicly released with no mention of actual GAAP earnings and without disclosing that the reported figures are adjustments to GAAP is against regulations. In these situations and others when the measures are not supplemented with audited amounts, proper explanation, and not in the right context, users can easily misinterpret them. The measures can be particularly confusing when analysts compare non-GAAP measures amongst companies in the same industry, principally when the measures are similarly titled and differently calculated.

Non-GAAP Measures Defined

A non-GAAP financial measure results from adjusting a commonly understood or defined GAAP measure or amount with other amounts obtained from the financial statements. By definition, they are numerical measures of a company's historical or future performance, financial position or cash flows that exclude or include amounts from the most directly comparable measure calculated and presented in accordance with GAAP in the company's income statement, balance sheet or statement of cash flows (or equivalent statements). This definition is intended to capture all financial metrics that depict a measure of performance or liquidity different from those presented on the face of the financial statements or cash flows, respectively, computed in accordance with GAAP.

Ratios that include components not calculated in accordance with GAAP are non-GAAP measures. Conversely, ratios or statistical measures calculated using one or both GAAP financial measures are not non-GAAP measures. For example, “same-store sales,” “sales per square foot” and “average sales per customer” are not non-GAAP measures when the sales figures are calculated in accordance with GAAP. Likewise, disclosure of a new product line’s estimated revenues or expenses is not a non-GAAP measure when the estimated amounts are computed in the same manner as the actual results would be computed under GAAP. A table presenting a breakdown of certain products’ revenues calculated in accordance with GAAP is not a non-GAAP measure, even if the table does not sum to the revenue presented on the company’s financial statements. The presentation could be considered a non-GAAP financial measure if the revenue is adjusted.

Non-GAAP measures exclude any measures required to be disclosed by GAAP, SEC rules or a system of governmental regulation or authority, or self-regulatory organization. For example, segment information presented in conformity with GAAP is not a non-GAAP measure, because GAAP requires the information to be disclosed.

Because non-GAAP measures provide numerical measures different from comparable GAAP measures, they exclude amounts such as expected indebtedness or debt repayment—amounts not provided under GAAP—and other operating or statistical measures commonly known as key performance indicators. These include metrics such as “unit sales” or “number of stores/employees/subscribers/advertisers.”

Performance Measures

Non-GAAP performance measures represent customized subtotalling at various points in the income statement. Examples include EBIT and EBITDA, which are non-GAAP financial measures because although widely understood, they are undefined in GAAP. Other non-GAAP measures such as “core operating earnings” and “core operating income” (terms undefined in GAAP), or “adjusted revenue/net income/EPS” are commonly used to only capture amounts that directly affect a company’s principal business operations. For example, the non-GAAP measure could exclude recurring “other expenses” or the effects of non-recurring, infrequent or unusual transactions that distort the results of core operations. Examples include one-time restructuring costs, acquisition, divestiture and
Non-GAAP Financial Measures

integration-related costs, asset disposition gains or losses, and unusual or infrequent stock compensation costs or impairment charges.

Certain non-GAAP measures are used when the accounting is clear, but the company desires to present enhanced, often more analyst-driven information. Frequently this is to aid in industry-specific comparability. Examples include financial institutions providing measures that exclude credit valuation adjustments (CVA), debt valuation adjustments (DVA) and the effects of foreign currency exchange fluctuations and taxes. Likewise, REITs commonly disclose FFO.

Although a non-GAAP performance measure may be considered customary, users may not know the metric’s definition, which could be different among companies and particularly for different industries. To facilitate enhanced comparison among years and within industries, registrants will want to ensure that the measure’s computations are defined in the disclosures.

Liquidity & Financial Position Measures

Non-GAAP liquidity measures relate to customized subtotals within the cash flow statement. Examples include “operating cash flows excluding working capital changes,” “adjusted cash flow from operations,” “free cash flow,” “cash flow excluding share repurchases/changes in debt” and “cash flow available for dividends.”

Financial position non-GAAP metrics commonly include tangible book value per share and tangible common equity.

Companies using non-GAAP financial position metrics will want to ensure it is clear that the “tangible” metric does not insinuate “available for expenditure.”

Oversight

Management & Governance Roles

Registrants are responsible for ensuring non-GAAP measures are not misleading, do not obscure relevant GAAP measures and are sufficiently transparent and comparable—among companies and between periods. This generally entails formalized processes operating within a suitably designed and operationally effective control structure that ensures the measure is reliable, accurate and not misleading—as well as meaningful.

Strong controls over the non-GAAP calculation and reconciliation to the corresponding GAAP measure, for example, should support accurate and complete explanations regarding why these metrics are useful to users and how management uses the measure that is not “boilerplate.”

To provide assurance over the usefulness of non-GAAP measures, and even enhance their usefulness, companies can consider implementing management review controls over the following processes:

- Consistently reporting non-GAAP and reconciliation information within each report and in reports over time
- Positioning the reconciliation of non-GAAP information to GAAP information near the non-GAAP financial measures
- Providing the definition of non-GAAP measures to eliminate confusion, especially for analysts comparing companies in the same industry
Non-GAAP Financial Measures

- Providing balance sheet and cash flow information with the non-GAAP earnings information in press releases to facilitate investor analysis

If the SEC staff believes a non-GAAP measure a company presents is not meaningful or may be misleading, the staff may request that the company remove the measure from its SEC filing or earnings release. Controls to help ensure that non-GAAP disclosures are meaningful, useful and within SEC rules may include: identifying profit measures that go beyond accepted industry practices, and identifying measures that eliminate items related to core operations, or that use different recognition and measurement principles than U.S. GAAP. Controls should also address transparency. Transparency and consistency controls should address reconciliation to GAAP, bias in calculation or explanation and consistent presentation from period to period. For example, when a non-GAAP measure includes a new adjustment, controls would help ensure that prior period measures also reflect similar items that existed in those periods.

External Auditor’s Role

Professional standards require auditors only to read other information in a document containing the financial statements and accompanying audit report. Non-GAAP measures are required to be outside the financial statements, in earnings releases or in the MD&A section of periodic filings. Hence, the external auditor’s opinion on the company’s financial statements and, when required, the effectiveness of the company’s internal controls do not cover non-GAAP measures.

General consensus is that there may be a prevalent expectation gap among financial statement users. They may expect that auditors have reviewed earnings releases, or are attesting to the company’s internal controls over non-GAAP measures, when they generally do not.

An auditor’s work on other information outside of the financial statements, including non-GAAP measures, is generally limited. The auditor has no responsibility for determining whether such information is properly stated. His or her responsibility is to read the other information in certain documents containing financial statements (such as annual and quarterly reports) and consider whether the other information—or the manner of its presentation—is materially inconsistent with information appearing in the financial statements. If so, the auditor should consider whether the other information needs to be revised and communicate the matter and potential consequences to those charged in governance.

Next Steps

Many agree non-GAAP measures are provided both as a result of demand pull from investors, and a push from the company’s desire for investors to fully understand the financial statements. Regulators besides the SEC are addressing the issue. FASB’s Financial Performance Reporting research project seeks to analyze why non-GAAP measures are increasing if GAAP financial statements are useful and not deficient of information needed for users to understand the company’s operations, cash flows and financial position. The Public Company Accounting Oversight Board (PCAOB) Investor Advisory Group met in October 2016 to discuss current issues with the reporting of non-GAAP measures along with other items.

The proliferation of non-GAAP performance measures could indicate the need for potential improvements to the current net-income operating measure, or further disaggregation among performance measurement categories—giving users better information to model future earnings. FASB’s project to consider defining the measure, however, may prove challenging because of the differences among diverse industries and across the range of a registrant’s business cycle.
We encourage companies to examine their non-GAAP disclosures against SEC rules and interpretations and reconsider whether the measures are useful and appropriately supplement their GAAP metrics. Together with amounts prepared under GAAP, complementary non-GAAP disclosures should help analysts and stakeholders enhance their understanding of the company’s underlying business.

Companies are wise to review their reporting process and accompanying internal controls. Effective non-GAAP internal controls ensure the measures are reliable, accurate, meaningful, fair and balanced.

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Non-GAAP Measures Regulations

Regulation G

Applicability

Regulations over non-GAAP measures have existed for more than a decade. The Sarbanes-Oxley Act of 2002 (the Act) directed the SEC to implement and enforce rules to enhance public company financial disclosures. Section 401 (b) of the Act directed the SEC, among other things, to adopt rules over non-GAAP disclosures and require they not be misleading. In 2003, the SEC adopted a new Regulation G, which applies to non-GAAP financial measures included in public disclosures made by registrants with any shares registered under the Securities Exchange Act of 1934 or required to file reports pursuant to the Exchange Act. It includes written or oral public information, such as earnings releases, CFO briefings and investor and industry group presentations.

A registrant disclosing material non-public information regarding its actual or expected quarterly or annual results of operations or financial condition for a completed fiscal period is required to furnish information to the SEC under Item 2.02 of Form 8-K. Registrants will follow Item 10 of Regulation S-K, discussed below, regarding Form 8-K non-GAAP financial measure requirements.

Requirements

The general requirement of Regulation G prohibits making public a non-GAAP financial measure that—taken together with the information accompanying that measure and any other accompanying discussion—misstates a material fact or omits a material fact necessary to make the presentation not misleading, in light of the circumstances in which the information is presented.

A non-GAAP measure is considered not misleading when a registrant complies with the following Regulation G requirements:

- Ensure the non-GAAP measure is accompanied by the most directly comparable GAAP financial measure and not given greater prominence than the GAAP measure, including forward-looking non-GAAP financial measures if the reconciliation can be performed without unreasonable effort
- Provide a quantitative reconciliation to the most directly comparable GAAP financial measure, with each adjustment clearly labeled, separately quantified and an explanation of why the various adjustments—individually or in the aggregate—are consistent with the measure’s intended purpose

The SEC has cautioned that non-GAAP performance measures should be balanced with GAAP net income or income from continuing operations, and non-GAAP liquidity measures should be balanced with disclosure of GAAP cash flows from operating, investing and financing activities. Registrants should accompany ratios where a non-GAAP financial measure is in the formula’s numerator and/or denominator by both: a reconciliation of each separate non-GAAP measure used in the calculation; and a ratio calculated using the most directly comparable GAAP financial measure(s).

Forward-Looking Information

The SEC indicated that if the most directly comparable GAAP measure is not accessible on a forward-looking basis, the company must disclose that fact, provide any reconciling information that is available without unreasonable effort, identify any unavailable information and disclose the probable significance of that information. A company is permitted to provide the projected non-GAAP measure, omit the quantitative reconciliation and qualitatively explain the types of gains, losses, revenues or expenses that would need to be added to or subtracted from the non-GAAP measure to arrive at the most directly comparable GAAP measure, without attempting to quantify all those items.
Non-GAAP Financial Measures

Narrative Information

The inclusion of adjustments will not comply with Regulation G and may be misleading if they are not accompanied by an explanation of why the various adjustments are consistent with the measure’s intended purpose.

Those registrants providing enhanced disclosure of what the non-GAAP measurement demonstrates, its limitations and how it is calculated, e.g., what GAAP components are being adjusted, why they are being adjusted and how they reconcile to GAAP numbers, enhance transparency and reduce potential confusion and SEC scrutiny.

Item 10 of Regulation S-K

Applicability

Also in 2003, the SEC adopted amendments to Item 10 of Regulation S-K—as well as Item 10 of Regulation S-B applicable to small business issuers and Form 20-F applicable to many foreign private issuers—in its final rule, “Conditions for Use of Non-GAAP Financial Measures.” Regulation S-K covers the use of non-GAAP information included in documents filed with the SEC under the Securities Act of 1933 and Securities Exchange Act of 1934, e.g., Forms 10-Q and 10-K/20-F.

Item 10(e) encompasses Regulation G’s requirements and adds the following more extensive and detailed qualitative requirements and prohibitions. Regulation S-K’s requirements extend to earnings releases and other nonpublic communications furnished to the SEC under the Form 8-K requirements.

Additional Requirements

- Provide a description of what each non-GAAP measure represents and the reasons why management believes presentation of the non-GAAP measure is useful to investors, e.g., why investors would find it valuable in the context in which it is presented, given the excluded items
- Provide an explanation of additional ways, if any, management uses the non-GAAP measure, e.g., for debt covenants or incentive compensation arrangements solely based on non-GAAP financial measures

Users rely on non-GAAP measures to provide fair and balanced insight into how management analyzes operations, and narrative information is an important part of the non-GAAP requirements. As a general rule, measures are considered useful if they are important to understanding the business. Understanding which metrics are used by peers may help management determine what information to include in its communications and why it may be useful. In situations where management is aware of differences in its calculations compared to peers, we encourage management to carefully explain the company’s disclosure and why the measures may be different.

We encourage companies to collaborate within their industry group to develop voluntary, industrywide metrics to enhance comparability.

The statements regarding why management believes the non-GAAP financial measure provides useful information and additional purposes for which management uses the measure may be provided in the company’s most recent annual report filed with the SEC (or more recent filing), provided they are updated as necessary as of the time of the filing of a document including the non-GAAP financial measure. Accordingly, issuers will not need to repeat this information each time a non-GAAP financial measure is used, so long as the previously disclosed information does not require updating.
Non-GAAP Financial Measures

Prohibitions

- Excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures—other than the measures EBIT and EBITDA
- Adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as nonrecurring, infrequent or unusual, when either the nature of the charge is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years
- Presenting non-GAAP financial measures on the face of—or notes to—the GAAP financial statements or on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X
- Using titles or descriptions of non-GAAP measures that are the same as—or confusingly similar to—GAAP titles or descriptions

Narrative Information

Regulation S-K’s narrative requirements include the manner in which management uses the non-GAAP measure to conduct or evaluate its business; the economic substance behind management’s decision to use such a measure; the material limitations associated with use of the non-GAAP financial measure as compared to the most directly comparable GAAP financial measure; the manner in which management compensates for these limitations when using the non-GAAP financial measure and the substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.

In situations where a registrant is not able to adequately explain how a non-GAAP measure is useful to investors or how management is using the measure in a non-boilerplate manner, management and the audit committee may reconsider its use. Measures should be consistent with the company’s business model and risks, and, as such, would be consistently used from year to year regardless of whether they make the business’s performance look better or worse. We recommend that management evaluate whether a non-GAAP measure can stand the test of time.

Interpretative Guidance

Following the issuance of Regulation S-K in 2003, the SEC staff and Division of Corporation Finance issued a series of publications, “Regarding the Use of Non-GAAP Financial Measures — Frequently Asked Questions (FAQs),” which significantly limited the use of non-GAAP financial measures in SEC filings. This resulted in many companies choosing only to present non-GAAP measures in earnings releases and other unaudited investor communications and excluding them from their SEC filings.

In 2010, the SEC released a series of less restrictive Compliance and Disclosure Interpretations (C&DIs). The C&DIs are interpretative guidance to clarify the rules and regulations over the use of non-GAAP financial measures. They supersede the FAQs and effectively encourage companies to disclose non-GAAP financial measures in their SEC filings if they did so in other financial communications.